A black and white photograph of the interior of a grand building, likely a state capitol. The image shows large, ornate arches and classical columns. The architecture is detailed with carvings and moldings. The lighting is soft, highlighting the textures of the stone and the depth of the arches.

*Governor Olene S. Walker's*  
**Recommendations**  
on a **Tax Structure**  
for **Utah's Future**

*November 2004*



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*November 2004*





## STATE OF UTAH

OFFICE OF THE GOVERNOR  
SALT LAKE CITY  
84114-0601

OLENE S. WALKER  
GOVERNOR

GAYLE F. McKEACHNIE  
LIEUTENANT GOVERNOR

November 2004

To the Citizens of Utah,

Last year, our state was emerging from a recession and future state obligations were looming. One of my first initiatives upon becoming Governor was to initiate an in-depth review on how to improve Utah's tax system.

Our state is growing and our economy is changing. The state's tax code is out-of-date. We need to modernize our tax system to keep pace with change if taxes are to remain fair and broad-based. It must also meet the financial needs of our growing state. In my various experiences in state government I have observed and been involved in the analysis of *portions* of the tax system. This time, we have looked at the *total* tax system.

The advisors I selected have solid backgrounds in tax policy, the state budget, and economic analysis. The group was purposely kept small to allow for intense investigation within a quick time frame. Input from others was welcomed and received.

The recommendations contained in this report meet the six principles I laid out a year ago when launching the effort. The recommendations create a system that:

- is fair, just and balanced,
- supports a business-friendly economic environment,
- focuses on funding critical needs,
- has structural balance,
- is a tax system for the 21<sup>st</sup> Century, and
- balances state and local obligations and revenue sources

I urge you to give serious consideration to the recommendations proposed, improve upon them where necessary, and implement tax reform as Utah's economic future is at stake.

Sincerely,

A handwritten signature in cursive script that reads "Olene S. Walker".

Olene S. Walker  
Governor

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*Governor Olene S. Walker's*

# Recommendations on a Tax Structure for Utah's Future



## EXECUTIVE SUMMARY

Utah's economic future is tied to a well-balanced tax structure. The tax structure needs to encourage economic development while supporting our citizens' need for education, roads, and other vital public services.

This report reflects a one-year, in-depth study of Utah's tax structure and gives recommendations on how it can be improved.

The first step in analyzing Utah's tax structure was to look at the tax base. We used techniques commonly used to analyze risks of investments and applied them to Utah's four major taxes: sales, individual income, corporate income, and property.

We made two important discoveries. First, the core base of most of our taxes, adjusted for economic growth, is declining. The sales tax base is declining at a rate of 1.3% per year, the individual income tax base is declining 1.4% per year, and the corporate income tax base is declining 8% per year. Only property tax is increasing at 3.8% per year.

Second, there is a substantial amount of volatility in the sales, individual income, and corporate income tax. If the Utah economy increases 1.0%, individual income tax grows 1.4%. But, if the Utah economy decreases 1.0%, individual income tax shrinks 1.4%. The problem is much worse for corporate income tax. Sales tax tends to track the economy. Property tax is fairly stable.

These findings show that Utah's tax base is eroding and volatile. Now, while the Utah economy is recovering, changes to the state's tax structure should be made.

The recommended changes are guided by the following principles. Utah taxes should:

- Be fair, just and balanced
- Support a business friendly economic environment
- Focus on funding critical needs
- Have structural balance
- Be a tax system for the 21<sup>st</sup> Century
- Balance state and local obligations and revenue sources

The recommendations are revenue neutral. They also take the approach of broadening the base and lowering the rate. It is important to broaden the base because it gives greater stability and flexibility to meet future needs. Lower rates encourage economic development and are less likely to distort business decision-making.

With these principles in mind, we submit this report. It is our hope that these recommendations will stimulate a state-wide discussion and debate so that crucial decisions to chart Utah's course in the coming years will be made.

# A Balanced System

## *Recommendation #1*

### **Retain the traditional “three-legged stool”**

Utah’s tax revenues are primarily derived from individual income and corporate income and franchise taxes, which tax income; a sales tax, which taxes consumption; and a property tax, which taxes wealth. Although no tax is perfect, we believe this general structure should be maintained. Utah will continue to experience economic cycles in the future. Diversification of our revenue stream, like a balanced investment portfolio, will minimize the risks associated with economic downturns, while capturing the benefits of economic booms. An overall tax structure that is balanced helps ensure that there are adequate revenues to meet critical needs. Notwithstanding this sound foundation, however, we believe that significant restructuring of the various taxes and a rebalancing of the tax portfolio is necessary to meet the needs of the 21<sup>st</sup> Century.



### **Recommendation**

Adopt a flat tax

Lower the rate

Eliminate deductions

Eliminate tax on individuals living below the poverty level

### **Benefits**

Simplicity

Ease of compliance

Broader base

More stability

### **Option 1: Adopt a flat tax rate based on federal taxable income (FTI)**

Utah’s structure could be radically simplified by eliminating most special deductions and credits and by basing our tax on federal taxable income. Under this proposal, most Utahns would receive a benefit for their personal exemptions and itemized deductions. We propose a single rate of under 5%. Lost revenue could be made up by an adjustment in the state-wide school property tax levy. This action would decrease the volatility of our education funding mechanism. We also believe lowering our top marginal rate is one of the most effective steps we can take to encourage top executives to relocate their businesses to Utah.

### **Option 2: Utah should adopt a flat tax rate based on federal adjusted gross income (AGI)**

In the alternative, we recommend simplifying Utah’s structure by imposing a flat rate, which could be about 4% on federal adjusted gross income. A standard deduction would be allowed for individuals and households below the poverty level. Other deductions would be allowed only for constitutionally required items, such as interest on federal obligations.

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## Individual Income Tax

## *Recommendation #2*

### **Adopt a flat tax, broaden the base, and lower the rate**

The individual income tax is the cornerstone of Utah’s education finance structure but at the same time is one of Utah’s most volatile taxes. The tax increases with growth in the economy and will provide most of the needed revenue for Utah’s increasing educational needs. Utah’s current income tax structure, however, contains a myriad of exemptions, most of which are little used, but add to the compliance burden of our taxpayers and create a perception of unfairness. Utah’s current individual income tax structure may appear to be progressive with the rates ranging from 2.6% to 7%. The top rate, however, begins at under \$9,000 for a married couple and under \$4,500 for a single taxpayer. Thus, the tax is essentially a flat tax without the benefit of simplicity that a true flat tax would provide.

# Corporate Income Tax

## *Recommendation #3*

### **Eliminate the Corporate Income tax**

Elimination of this tax would send a strong signal to the business community that Utah is a good place to invest capital, either in new or expanding business opportunities. The lost revenue, in the short-run, could be recouped by increasing the state-wide school levy. In the long-run, we believe additional economic growth will more than offset the lost revenues.



#### **Recommendation**

Eliminate the corporate income tax

Adjust the state-wide school levy to offset lost revenues

#### **Benefits**

Encourages business formation in Utah

Attracts new businesses to Utah

Eliminates complexity of compliance with current law

Levels the playing field among Utah businesses

Ends discrimination based on type of entity

Ends discrimination based on type of business

Ends discrimination based on "non profit" status

We recognize that policy makers may not be able to eliminate such a significant revenue source in the near future. If the corporate tax is to be retained, there are changes that should be considered.

### **Change 1: Double-weight the sales factor**

Consideration should be given to double-weighting the sales factor used to apportion multistate income. When Utah adopted the equally weighted three-factor formula, it was the national standard. In an attempt to assist local businesses and attract new plant and payroll, the majority of states are now giving extra weight to the sales factor. Utah should follow suit. A formula similar to other states will be more equitable for multistate business, reducing the likelihood of double taxation. By lessening the tax burden of companies with payroll and property in the state, we will encourage the creation and expansion of businesses in Utah.

### **Change 2: A minimum filing threshold should be established for multistate businesses**

It is currently difficult for a business without significant operations in Utah to know when it should file a return and pay Utah's minimum tax. We recommend that a company with minimal amounts of property, payroll or sales in the state not have to report Utah corporate income tax, even if it had constitutional nexus.

## Sales Tax

The sales tax provides most of the tax revenue for Utah's general fund. It tracks the economy quite well and is more stable than the income tax. There are several problems with the tax. First, the overall sales tax base is declining. There is a long-term shift in the economy to services rather than goods. The current tax base does not capture many of these services. Also, there are numerous sales tax exemptions that cause Utah businesses to shoulder widely differing tax burdens.

Second, many business "inputs" are subject to the sales tax, but when the product or service is sold, another sales tax is charged. This "pyramiding" effect increases the cost of Utah goods and decreases their competitiveness with goods produced in lower cost states or countries.

Third, local retailers, that must collect Utah sales taxes, are at a competitive disadvantage compared with remote out-of-state retailers who do not have that burden.

Finally, the large number of local rates significantly increases the compliance burden for many businesses.



#### **Recommendation**

Enact a true "consumption" tax

Broaden the tax base to include consumer services

Lower the rate

Provide a uniform exemption for business capital expenditures

Exempt most business-to-business services

### **Benefits**

Revenues would keep pace with the economy

Revenues would be more stable

Broadened base should make the tax more progressive

Utah businesses would be more competitive with national and international competition

Tax would be fairer for Utah businesses because all types of businesses would receive similar exemption treatment and bear similar compliance burdens

Reduces “pyramiding”

## *Recommendation #4*

### **Simplify and expand the sales tax exemption for business inputs**

Most of the sales tax exemptions currently in place should be removed and replaced with a single exemption for capital assets purchased by Utah businesses, regardless of their line of business. Exemptions for sales to governmental and charitable institutions would remain in place.

## *Recommendation #5*

### **Broaden the base of the sales tax to include services**

The sales tax base should be expanded to include most consumer services. This will prevent the continuing erosion of the tax base as the economy continues to evolve. The tax base would include most professional services provided to individuals. (Educational services provided by Utah’s colleges and universities would not be taxed.) Because a disproportionate amount of these services are purchased by higher income taxpayers, expanding the base would also make the sales tax less regressive. Professional and other services performed for businesses, however, would not be taxed. This will prevent “pyramiding,” maintain Utah’s competitiveness

in the national and global market, and avoid inequities between large businesses that have extensive legal, accounting and other service departments, and smaller businesses that often outsource such services.

## *Recommendation #6*

### **Monitor the rate of the sales tax**

The broadening of the sales tax base should result in significant revenue that can be applied to lower the rate. The recommended changes are so extensive that exact estimates are impossible. The legislature should require automatic reductions in the tax rate when established revenue targets are met.

## *Recommendation #7*

### **Continue to participate in the Streamlined Sales Tax Project (“SSTP”)**

The SSTP will dramatically simplify nationwide sales tax compliance for multistate businesses. It is also the most promising way to level the playing field between Main Street Utah retailers and their out-of-state remote competitors.



### **Recommendation**

Participate in the SSTP

### **Benefits**

Helps Utah retail businesses compete with out-of-state retailers

Simplifies tax compliance for multi-state business

Prevents further erosion in Utah’s tax base

Improves progressivity by increasing collections on many discretionary purchases

## *Recommendation #8*

### **Simplify the local rate structure**

Local governments should simplify their rate structures, eliminating the myriad local-option taxes that have crept into the sales tax. Ideally, Utah should have one

combined rate for both state and local entities, with the revenues distributed based on population. This will dramatically simplify sales tax compliance for our retailers. If a local government's revenues drop below current levels the distribution formula could contain a hold-harmless provision.



### **Recommendation**

Simplify the local sales tax structure

Equalize the tax rate state-wide

Distribute revenues based on population (with a "hold harmless" provision)

### **Benefits**

Dramatically simplifies compliance for Utah businesses

Avoids "zoning for dollars" and helps ensure that communities implement sound land use policies

Levels the playing field among Utah businesses

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## Property Tax

### *Recommendation #9*

#### **Retain the general structure of the current property tax**

The property tax is established by the Utah Constitution and is the most stable of the major taxes. We believe the general structure of the property tax should be retained. We propose an adjustment in the state-wide school fund levy to offset our proposed reductions in other taxes.



### **Benefits**

The property tax is our most stable source of revenue

### *Recommendation #10*

#### **Restructure water funding**

Property and sales taxes should generally not be used to fund water districts. Water is a precious resource in our state. Its use should not be subsidized with property or sales taxes. We believe that full funding by user fees will encourage conservation and leave more water available for critical agricultural use. There may be exceptions for districts that are predominantly engaged in providing irrigation water for agricultural use, or have other unique needs. Alternate funding mechanisms for capital projects for new or rapidly growing urban and suburban districts should also be made available until there is an adequate stream of operational revenues.



### **Benefits**

Water conservation will increase

Taxpayers will not be required to subsidize other water users

### *Recommendation #11*

#### **Study centrally-assessed property**

Both local government and centrally-assessed property owners believe they are being treated unfairly. We recommend a summit be convened among local government leaders and chief executives of centrally-assessed companies to address perceptions of unfairness.



### **Benefits**

All parties could benefit from an increased level of dialogue and understanding

### *Recommendation #12*

#### **Allow school districts and other special districts to choose whether to participate in redevelopment initiatives**

We believe that taxing entities, especially school districts, should have the right to determine whether or not their future tax revenues will be diverted to an RDA.



### **Benefits**

Local government and education funding would be enhanced

RDA use would be limited to the most deserving circumstances

### *Recommendation #13*

**Local entities should be allowed to adjust revenues for inflation without going through Truth-in-Taxation hearings**



### **Benefits**

Local governments' cost of doing business increases with inflation, just as other businesses' do

Reluctance to increase property taxes has encouraged reliance on other fees and taxes that are less transparent, less fair and more unstable

Reluctance to increase property taxes encourages officials to delay necessary decisions until there is a crisis

components, one tied to usage and one tied to price. Local governments would also receive sales tax revenues from fuel sales, which would help fund local streets and roads.



### **Recommendation**

The sales tax exemption for motor fuel and special fuel taxes should be removed

The per gallon taxes should be reduced to avoid a windfall

The change could be delayed until such time as the Governor and the Legislature believe an increase is necessary

### **Benefits**

The revenue would keep up with inflation

The stability of a cents/gallon rate could be retained

Local governments would receive local sales tax revenues they could use for their streets and roads

## Motor Fuel Tax

### *Recommendation #14*

**Repeal the sales tax exemption for motor fuels and reduce the per gallon rate**

Motor fuel taxes are currently based on a fixed amount per gallon. Accordingly, they increase with usage, but not with increases in the cost of living. A tax based entirely on sales price, however, would be unreliable, given the significant fluctuations in gasoline prices.

We recommend repealing the sales tax exemption for motor fuels. The Legislature could then reduce the "per gallon" charge to avoid an unwarranted tax increase. The tax would thereafter have two

## Severance Tax

### *Recommendation #15*

**The current two tiered tax rate on oil and gas severance tax should be simplified and revenues should be dedicated to capital projects or community or economic development**

Severance taxes come from a non-renewable resource and some portion of the additional revenues should be used for long-term economic development and capital improvements.



### **Benefits**

The state should be adequately compensated for the loss of a precious resource

Simplification of the tax

# State Inheritance Tax

## *Recommendation #16*

**The state inheritance tax should be retained as long as there is a federal estate tax**



### **Benefits**

The state continues to receive tax revenue at no additional cost to the taxpayer

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## Summary

We recognize these are bold recommendations and change is always difficult. We are confident that an objective evaluation of these recommendations will occur and necessary improvements to the proposals will be made. Implementing tax reform will benefit Utah's taxpayers now and in the future.

# *Governor Olene S. Walker's* Recommendations on a Tax Structure for Utah's Future



## Goals

We have identified six principles to guide the tax reform effort that began in January of this year. Upon completion of the tax reform efforts, the Utah tax system should reflect the following principles:

- be fair, just and balanced
- support a business-friendly economic environment
- focus on funding critical needs-including education
- have structural balance
- be a tax system for the 21<sup>st</sup> Century
- balance state and local obligations and revenue sources

## Utah's existing tax base

### Analysis of Utah's tax base

Before evaluating Utah's tax system, we felt it was important to understand the historical patterns of the various tax bases and tax rates. We developed a process to analyze the data. The process allowed us to dissect and scrutinize the historical revenue patterns of the major state revenue sources. The same techniques have been used in analyzing financial markets for over 30 years. (See Appendix 1 for a presentation of this analysis.)

There is a common assumption in making financial decisions that investors face a trade-off between high growth with greater risk or low growth with less risk. The financial community has developed a technique that allows the comparison of investment choices, taking into account the relationship between the growth in the value of the investment and the potential of the downside risks.

When analyzing stocks an assessment is made on how much the value of an individual investment has increased or decreased relative to financial markets in general. The proxy for the financial market is the S&P 500 (which tracks value changes in 500 stocks). If an individual stock changes value at a rate that is less than the rate of change in the S&P index, it indicates a stock that is stable, less risky, and does not change as rapidly as the market, but it is also a stock that does not increase in value as rapidly as the market does. Investors are left with the decision to accept slow growth with lower risk, or faster growth with more risk. The danger of risk is that when the economy goes through a downturn, the potential for substantial loss is very high.

### Utah's tax system as a stock portfolio

We applied a similar analysis to determine the stability or risk on the sales tax, the individual income tax, the corporate income tax, and the property tax. The overall trend in the revenues and the tax base was calculated on each of these four major taxes. We looked at how the revenue from each tax responded to changes in the business cycle over the past 20 to 25 years.

### Decline in the tax base

From 1980 to the present, Utah has experienced four downturns in its economy and four upswings. Our analysis first revealed that after adjusting the revenue trends for the growth spurts or slumps of the business cycle, three of the major taxes are failing to keep pace with the economy. The most likely explanation for this trend is a decline in the tax base.

The declines were masked by the changing patterns of growth associated with the business cycles. For example, if the data for sales tax revenue are adjusted for the changes in the economy, the sales tax base is declining at

a rate of 1.3% per year. Likewise, when the same adjustments are made for the individual income tax, the tax base is declining at a rate of 1.4% a year. The corporate income tax base is declining at a rate of 8.0% a year. The only tax that was not experiencing a decline in the base was the property tax, which actually increased 3.8% per year.

### Volatility in sales, individual income and corporate taxes

The second finding of the analysis was the substantial amount of volatility in the sales, individual income, and corporate taxes. If the Utah economy increased 1.0%, the income tax revenue would increase 1.4%. This would be just enough growth to offset the decline in the base. If the Utah economy was always growing, this rate of growth would allow state policy makers to occasionally decrease the tax rate or increase spending. However, a problem arises when the economy slows—and the economy does slow. A 1.0% decline in the Utah economy results in a 1.4% decline in the revenues from the individual income tax. A somewhat similar pattern exists for the sales tax and the problem is much worse for the corporate income tax. For every 1.0% decrease in the economy, the corporate income tax decreases by almost 2.0%. The property tax grows much slower than the other three taxes, but it is significantly more stable. These patterns are illustrated in Figure 1.

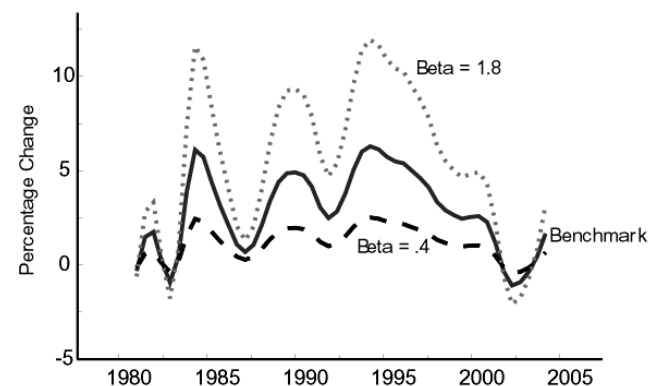


Figure 1. Volatility of Utah revenue resources.

### Concern for Utah's tax system

The obvious conclusion is that there are fundamental challenges to the Utah state tax system. There is a heavy reliance on taxes that are volatile and whose base is eroding. This is also coming at a time when Utah is facing a substantial surge in the school age population. Given our findings on the trends in Utah's taxes, the expectation that we will be able to count on economic growth to fund K-12 public education and higher education, along with Utah's other financial obligations, may be unrealistic.

## Goal #1

### Be fair, just and balanced

Fairness and justice, especially in taxation, are often in the eye of the beholder. For example, many people believe that the income tax should be at least moderately progressive. Others favor a flat or proportional income tax. Most would agree that regressive taxes should be avoided or used with caution.

Some believe that a reasonable or just tax system appropriately pursues social policy goals such as providing economic incentives to business firms, subsidizing the development of water projects, or providing income to individuals and families below the poverty level. Others feel that a fair tax system is revenue driven and the first question that must be asked is if the system generates sufficient and consistent levels of revenue. Such individuals likely believe that the use of the tax system for social or economic engineering should be kept to a minimum.

Feelings about tax fairness also have implications about the size of government. Some believe that a fair system means that the government should use tax revenues to fund only a minimal level of services and that any additional public services should be funded with fees that are paid by those who use the service. Others believe that a wider range of services should be funded with taxation and should be generally available to citizens, without regard to their ability to pay. They worry that low income individuals and families may not be able to afford some fundamental services if they are funded by fees and charges.

Balance in the tax system is somewhat easier to agree upon, but finding a proper balance entails many of the

same judgment questions outlined above. However it is easy to argue that balance is undermined when there is too much reliance on one single tax.

### **Qualities of a fair, just and balanced system**

We believe that a fair, just and balanced system should have the following qualities:

- **Economically neutral**

First, the tax system should be as “economically neutral” as possible. A poorly designed tax system may undermine the efficiency of the overall economy. If tax and fiscal concessions distort economic decisions, they tend to reduce the efficiency of the total economy. Distortions are most likely to occur when state and local governments compete against each other for businesses using tax or expenditure incentives. This competition occurs not only between state governments but also between local governments.

A lack of neutrality also affects equity. A tax system should not offer direct or indirect tax incentives that favor certain forms of business over others. For example, the system should not give direct tax advantages to new firms while not offering a similar incentive to older established firms. There is a general consensus among tax experts that the tax base should be broad, so that taxes reach as many activities as possible. A broad tax base promotes equality between individuals and institutions and also contributes to a stable flow of revenue. A broad tax base also enables a state to keep tax rates relatively low.

With these points in mind, it is clear that exemptions and credits should be allowed only for compelling reasons. For example, tax breaks that will stimulate the economy and “increase the pie” may be appropriate because they ultimately lower the tax burden for everyone. But tax breaks that simply redistribute the tax burden—by giving advantages to a limited number of recipients—should be avoided.

- **Ability to pay**

Second, the taxpayer’s tax burden should have some relationship to an individual or a family’s ability to pay. In practice this means that the tax system, overall, should not be regressive. That is, it should not tax lower income citizens relatively more heavily than higher income citizens. This outcome is not always easy to achieve.

Each major tax has advantages and disadvantages. The sales tax is a good illustration. The sales tax is able to generate a substantial amount of revenue for state governments but it is generally thought to be regressive. If this was the only source of revenue a state relied upon the outcome would be regressive. But with a balanced tax system, an income tax that is slightly progressive can offset the regressive nature of the sales tax. Or in the case of a flat tax rate the income tax can be adjusted to directly protect low income individuals and families from the regressive effects of a sales tax. Moreover, if the tax base is broad, the rates can be kept low, thus easing the burden on those who do have to pay taxes.

- **Balance among various taxes and fees at all levels of government**

Third, there should be an appropriate balance among various taxes. The current three-legged stool wherein income is taxed by the income tax, wealth is taxed by the property tax, and consumption is taxed by the sales tax is generally sound and should not be abandoned. However, the relative weighting in the current tax system in Utah was established many years ago when the Utah economy was much different and it seems prudent to reexamine the weighting among those taxes.

One of the most important reasons to be concerned about balance in a tax system is illustrated in Figure 1. As seen in Figure 1, a 1.0% change in the state’s overall economy results in a 1.8% change in the revenue from the state corporate income tax. Such a change may be acceptable during an economic spurt, but when the economy slows the state corporate income tax slows even more rapidly. This degree of volatility makes budget planning difficult. Again, as shown in Figure 1, the property tax behaves much differently. When the economy grows the property tax grows at about one-half the rate, but when the economy slows the property tax is much less likely to fall as fast. When states rely on more than one tax they can use the differences in the buoyancies of the taxes to offset the changes that result from economic cycles.

- **Compliance**

Finally, when designing a balanced tax system, policy-makers should carefully consider ease of compliance and collection and transparency or openness. It is

clear that a retail sales tax works relatively well because the burden of compliance is placed on the retailer, not the consumer. (In Utah we compensate retailers for collecting and remitting the sales tax.) Similarly, the income tax works as well as it does because the primary collection tool is wage withholding.

On the other hand, we believe it is important that taxpayers understand what they are paying in taxes. Accordingly, sales taxes are separately stated on sales invoices and income tax withholding is listed on payroll stubs and W-2's. Other fees and taxes, however, are imbedded in the price of a product and the taxpayer may not know how much of the price is due to tax. For example, the amount of state and federal taxes imposed on cigarettes and beer are probably not completely understood.

## *Goal #2*

### **Support a business-friendly economic environment**

#### **Fair share**

All segments of the community, including businesses, should pay their fair share of the tax burden. The share of the tax burden that is paid by the business community should be evenly distributed throughout that community. There should be a level playing field. No business should have a comparative economic advantage because of state tax policy. Likewise, a business should not face a comparative disadvantage because of state tax policy. With a properly designed tax system, each segment of the economy contributes a fair share of tax revenue and each firm or business within that segment also contributes a fair share. As noted above, fair distribution of the burden usually connotes a broad base, with a correspondingly low rate. In fact, the ability to have a tax system that results in a fair distribution of the burden is directly related to how broadly the tax base is defined.

#### **Compliance**

Ease of compliance is also significant to businesses and care must be exercised to ensure that the costs of compliance are justifiable given the amount of tax collected. Moreover, the amount of tax that should be paid on any transaction or property should be predictable. Thus, a certain level of certainty and simplicity is necessary. Too much complexity, in pursuit of absolute fairness, will in time become counter-

productive. For example, a company that self-manufactures a portion of its machinery will have a different sales tax burden—generally a lower tax burden—than a company that opts to purchase its machinery. An effort to impose a sales tax on the company's labor and overhead to produce such machinery, however, would be unduly cumbersome to both the taxpayer and the tax administrator. The differential tax burden is justified by practicality.

#### **Tax incentives**

Tax incentives also contribute to a “business-friendly” economic environment, to the extent they do not unduly interfere with fair competition. Any such incentives, however, should be carefully crafted to ensure that they accomplish their intended goals. There are several potential pitfalls that must be considered when contemplating tax incentives.

First, if there are benefits associated with tax incentives they may be short-lived. Tax incentives are tools that all governments have at their disposal. As soon as one state offers concessions that may cause businesses to change their behavior or location to take advantage of the tax break or subsidy, neighboring states have strong incentives to offer tax concessions that meet or exceed those of the first state. In the final analysis, every state can play the tax concession game, eliminating any long-term advantages from tax concessions. The net result may be that all states end up with a less productive and less equitable tax structure without realizing any benefits of industrial or commercial expansion.

Next, benefits may flow largely to nonresidents. Since benefits from industrial and even commercial growth often spread beyond the boundaries of the sponsoring government, the state that bears the cost may not reap the benefits. There is no guarantee that workers employed by a new business will come specifically from the state offering the concessions. Many may be hired from neighboring states or from distant regions.

The goal of taxation, in the final analysis, is to generate revenue to support public services. In the short run, any policy that sacrifices tax revenue must either reduce public services or turn to other sources of replacement revenue. In the long term, the effect on revenue depends on whether expansion in the tax base will produce sufficient revenue to cover any related public service costs.

In designing a tax system that is “business friendly,” policymakers should remember that Utah is a relatively small state with a large amount of interstate and international commerce. This commerce flows both into and out of Utah. Thus, Utah’s system must be one that takes into account both the federal tax system and the systems of surrounding states. An unusual tax system, even if well-designed, would probably discourage many businesses from doing business in Utah because of the need to comply with a whole new system just to enter a relatively small market.

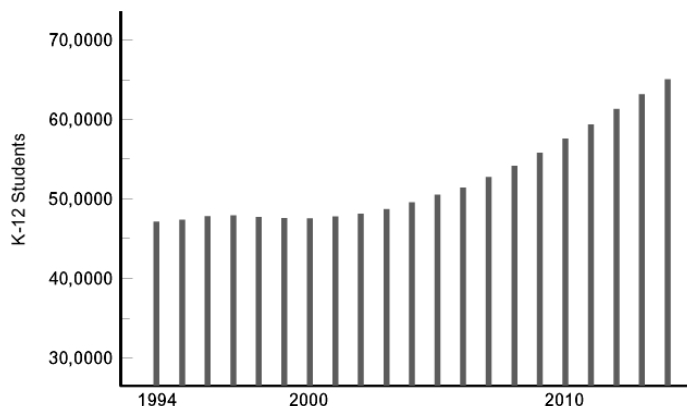
### *Goal #3*

#### **Focus on funding critical needs**

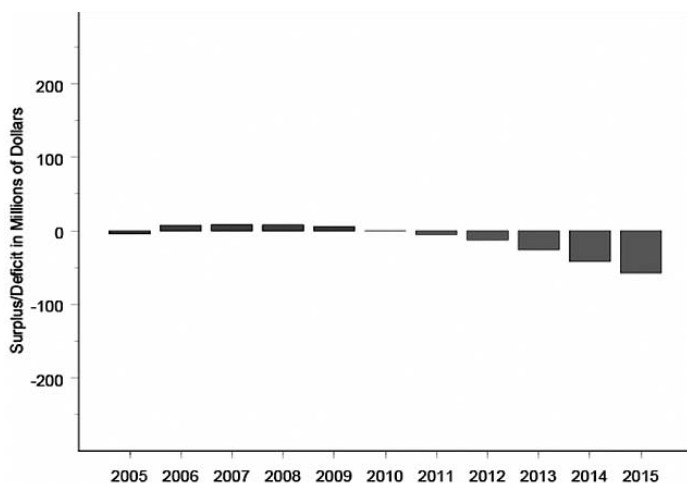
A good tax system must provide adequate revenues for the needs of the government. It is critical that the revenues are adequate through all stages of inevitable economic cycles. A balanced tax system that is not unduly reliant on a single tax provides stability to government revenue. Likewise, a tax system that relies too heavily on volatile taxes will not provide stability.

We have identified increasing needs in education, transportation, Medicaid, and corrections. There are special challenges in education because of the large increase in the number of expected school children, as shown in Figure 2. During most of the 1990s, total state-wide school enrollment increased less than 20,000 students. But as Figure 2 illustrates, the next 10 years could result in over 145,000 additional students. Obviously, relative to the previous decade the expected increase is dramatic. If Utah students are going to compete in the 21<sup>st</sup> Century, education funding must be a priority of the state.

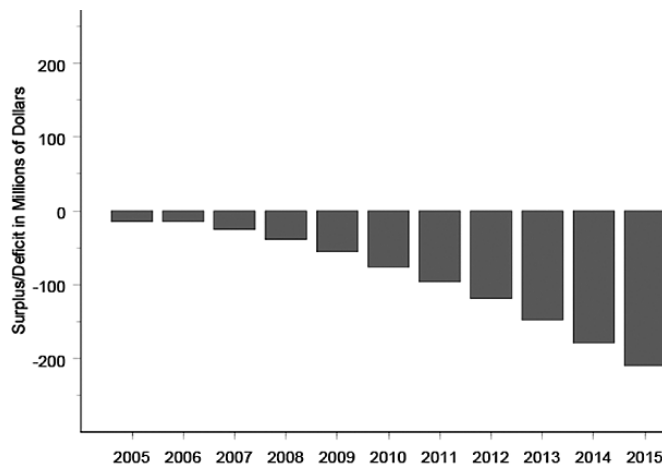
As the state population grows we expect an increase in state tax revenue. For example some sales tax growth can be anticipated from the expenditures used to feed and clothe the additional school children. Similarly, income tax revenues can be anticipated to increase as new wage-earners enter the work force. However, when we match expected revenue from the current tax structure with the anticipated increase in the number of children, we anticipate a dramatic shortfall in needed revenue. This outcome is illustrated in Figures 3 and 4. Figure 3 illustrates that if Utah experiences an annual growth in nonagricultural wages of 5%, we anticipate a modest surplus, but eventually a deficit in the Uniform



**Figure 2. Actual (1994-2003) and projected (2004-2015) school enrollment (K-12)**



**Figure 3. Estimated Uniform School Fund surplus or deficit at 5% constant growth rate in nonagricultural wages.**



**Figure 4. Estimated Uniform School Fund surplus or deficit at 4.5% constant growth rate in nonagricultural wages.**

School Fund. However, if nonagricultural wage growth drops by 0.5% to 4.5%, the Uniform School Fund faces sizable annual shortfalls, as seen in Figure 4. In these figures we have kept expenditures per pupil at current levels and have not adjusted for the increased cost of educating substantial numbers of students whose primary language is not English.

## *Goal #4*

### **Structural balance**

This principle has been touched on above. We list it again with the primary emphasis on the need to maintain the State's AAA bond rating. Utah is one of only a few states that benefit from the highest rated bonds from the three major national rating agencies. Government debt is an essential and appropriate component of government funding. Just as debt is used by the private sector to fund larger projects, long term debt allows the state to finance projects such as buildings and roads that otherwise might not be built. Debt also distributes the cost of the asset to individuals and families who relocate into the state and in some cases to future generations, all of whom will benefit from the capital expenditure.

Higher rated bonds are more attractive to investors, making it easier to raise capital. In Utah, debt has traditionally been used sparingly and has been limited largely to capital projects. However, when Utah decides to use debt, our high bond rating allows the state to borrow funds at lower rates, resulting in lower debt service payments. Debt service, of course, is typically paid with taxes or fees. Thus, lower interest rates translate into lower taxes.

"Structural balance" requires a reliance on several different tax types, each as broadly based as possible. It should also reflect an appropriate balance between funding from current revenue sources and debt. It should reflect an appropriate balance between taxes and fees. In general, fees and charges ought to be utilized to charge those who use a discretionary service. When fees are used, the market forces of supply and demand can help determine the appropriate quantity and quality of public services.

## *Goal #5*

### **Be a tax system for the 21<sup>st</sup> Century**

This principle simply reflects the fact that our current tax system was designed primarily for a mining, manufacturing, retail and agricultural economy. An ideal tax system will ensure that those segments of the economy still contribute an appropriate amount of tax revenue. It will also recognize, however, the changes that have occurred (and will continue to occur) in the economy. Those changes include:

- the growth of interstate and international business
- the increasing importance of intangible property, both as a store of wealth (i.e., stocks and bonds) and as an object of commerce (i.e., digital goods, software, patents and copyrights)
- the increasing importance of services in the gross state product
- the relative decrease in mining and manufacturing in Utah

Increased competition with interstate and international business is a two-edged sword. Utah clearly benefits by having its local businesses compete, market, and sell Utah goods and services in international markets. When state and local taxes are imbedded in product or service cost, they are passed forward to non-Utah consumers. If those taxes are too high, however, Utah businesses will not be able to profitably compete in out-of-state markets. Utah businesses must also compete in local markets with inbound business. Money spent on such imported goods typically adds less to Utah's tax revenues. Out-of-state businesses rarely collect our sales tax, rarely pay local property taxes and, with some exceptions, only pay personal or corporate income tax if they have a physical presence in the state.

### **Intangible property**

The increasing importance of intangible property, on the other hand, is largely a loss to the existing revenue system. Under the Utah constitution, intangible property is exempt from property tax if the income from the property is taxed. This means that an individual who owns \$1,000,000 of commercial rental property pays over \$10,000 in property tax each year, while an individual who chooses to invest the same \$1,000,000 in stocks and bonds pays no property tax. Similarly, a technically focused business whose primary assets are

intellectual property pays little property tax, while a manufacturing company, that may be less valuable overall, pays a much higher property tax. Thus, although the property tax was designed, in part, as a tax on wealth, it clearly favors some forms of wealth more than others and ignores the most rapidly growing forms of wealth in the new economy.

### **Services**

Finally, the amount of the economy derived from services is increasing. Most services are currently untouched by the sales tax. When the sales tax was first imposed in Utah the majority of economic activity was subject to the sales tax because it was a tax on goods and goods dominated the economy of the 1930's. The initial pattern of taxing the majority of transactions has changed as the economy has changed. Failure to keep the sales tax current with the evolving economy may unfairly shift the tax burden. For example, a parent must typically pay sales tax on the shoes bought for his or her child, but a hair cut and manicure are tax-free.

## *Goal #6*

### **Balance state and local obligations and revenue sources**

This principle is easy to state, but difficult to apply. Most Utahns, with our strong sense of self-determination, would probably say instinctively that the government governs best that is closest to the people. Delivery of services at the lowest level, however, may not always make economic or administrative sense. There are undoubted economies of scale when services are provided at the state level.

The potential for economies of scale suggests that choices must be made about the services that are provided at the local level and those that are provided by the state. Police and fire protection have largely been left to local governments, yet it would not make sense for each county to have its own maximum-security prison to house a handful of prisoners. Streets and roads are primarily local responsibilities, but much of the daily commute in urban and rural areas occurs on federal or state highways. Health care is traditionally a non-governmental responsibility, with citizens responsible for their own care (often through employer subsidized insurance.) Public health and indigent care, however, have traditionally been a local responsibility. The advent

of Medicaid has shifted much of the health care obligation from the local level to the state.

Providing and funding education is also problematic. Most Utahns strongly support local control of their schools, through locally elected school boards. There is also recognition, however, that each child merits a certain basic level of education, regardless of the financial circumstances of the area in which he or she resides. The quality of a child's education should not be determined by the wealth of the child's neighborhood or community. Thus, the state dedicates all of its income taxes to education, the bulk of it to K -12 education, to underwrite and equalize a certain level of funding. The remainder of the income taxes goes to help fund higher education, which is generally recognized in Utah as a state responsibility.

There is little dispute that local revenue needs are great. Likewise, local revenue sources are limited and very unequally distributed. Local governments rely extensively on property taxes, local option sales taxes, fees, and user charges. There are other options, such as a local income tax, that Utah has chosen not to use. Local income taxes would be problematic to apply for several reasons. Many local citizens, for example, work in jurisdictions other than where they live. Similarly, local government boundaries are largely irrelevant to many businesses. It is difficult enough to apportion the appropriate amount of income of a multistate business to the states in which it does business, let alone to specific towns, cities or counties. (There are states, however, like Ohio and Indiana where local option income taxes have been used.)

Much of the local tax base is dependent on state decisions. The local sales tax base for example, is largely based on the state sales tax base. As a result, any recommendation to alter, and hopefully improve, the state sales tax base has direct implications for local governments.

# Recommendations

## Scope of analysis

We reviewed all taxes, but focused on the major taxes where meaningful change would make the most difference in improving Utah's tax structure.

## Revenue neutral

As a package, the proposals are revenue neutral. Our goal was to analyze the Utah tax system and recommend changes to reflect sound tax policy. Raising taxes is not the intent. The proposals encourage economic development and take Utah's underlying economy into account. The result will be a tax system that will provide structural balance, grow with the economy, and not impede economic development.

## Broaden the bases, lower the rates

One of the general themes that emerged was that the tax bases should be broadened and, to stay revenue neutral, the rates should be lowered. Lower tax rates will benefit Utah businesses in two ways. First, businesses will be more efficient because their decisions will be based on sound economic and business principles, not on tax consequences. Second, lower rates on any particular transaction or enterprise will make it easier for that transaction or enterprise to compete successfully in today's global economy.

## *Recommendation #1*

### Retain the traditional "three-legged stool"

Utah's tax system is relatively balanced. It has been likened to a three-legged stool comprised of income, sales and property taxes. The income tax is constitutionally dedicated to education. Sales tax primarily funds the general state budget. Sales tax also provides an ever increasing share of local revenues, funding both ongoing operations and special needs such as mass transit, arts and culture, rural hospitals and rural roads. The property tax funds local government, including schools, both at the district level and through the Uniform School Fund.

In recent years, the legs of the stool have grown at different rates. The differences in the rates of growth have been determined to some degree by legislative changes but for the most part by the evolving Utah

economy. Thus, income tax revenues are now predominant, with sales taxes second. Property tax revenues have increased at the slowest rate of the three. There have also been significant differences in the responsiveness of the major revenue sources to the business cycles. (A chart showing the relative growth of major taxes in Utah over the last several years is attached as Appendix 2. A table of all major tax revenues over the last several years is attached as Appendix 3.)

By taxing income, wealth, and consumption, Utah's tax system has a solid foundation. It taxes all segments of the economy and most segments of the population and supports a business-friendly economic environment. Utah has recently been recognized by the Council on State Taxation as having one of the lowest tax burdens on business in the nation. (A copy of the report is attached as Appendix 4.) Using a different methodology, the Economic and Statistical Unit of the Utah State Tax Commission reports a similar conclusion in finding that the tax burden on businesses is lower than most of our neighbors. (A copy of that report is attached as Appendix 5.)

Because the system imposes a tax on three distinct tax bases, it is better suited to funding ongoing and often critical needs in spite of business cycle swings. For example, in economic downturns, property taxes provide a relatively stable base. In other words, the decline in the property tax revenue during a slow economic period is not as dramatic as the change in revenue from other taxes. Because Utah taxes many staples, such as food and clothing, the sales tax also provides a relatively stable base.

Of course, in boom periods these stable taxes don't increase as rapidly as other taxes. During periods of rapid economic expansion the personal income tax and corporate income tax aggressively respond to economic growth. But during periods of decline income-based taxes decline more rapidly than the actual decline in the economy. A broad based tax system provides protection during such swings. Some taxes are very responsive to swings in the economy and others are insulated from the swings. Where the effect of all taxes are combined, the result is a relatively predictable flow of funds. We believe that a broad-based approach to state taxation is essential for the 21<sup>st</sup> century. Many of the states that have

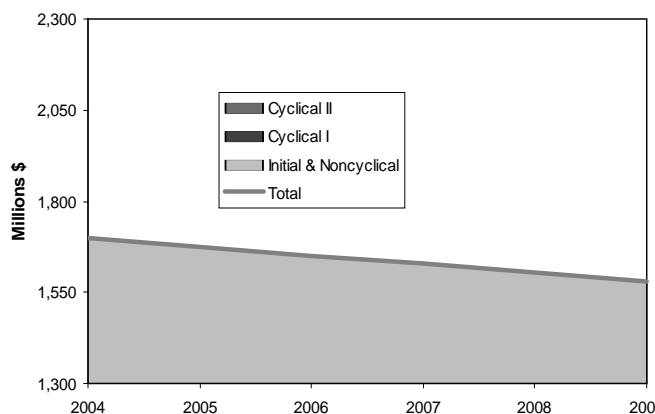
recently suffered greater fiscal crises than Utah have tax bases that are significantly narrower. Finally, the broad base allows a high degree of flexibility in balancing state and local revenue sources.

Notwithstanding this sound foundation, we believe that significant restructuring of the various taxes and a rebalancing of the tax portfolio is necessary to meet the needs of the 21<sup>st</sup> century.

## *Recommendation #2*

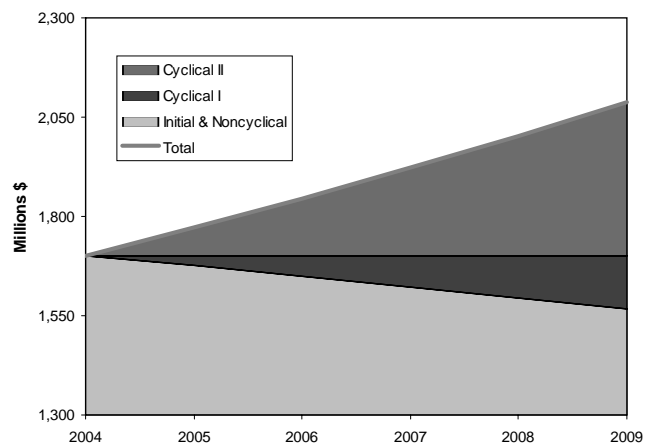
### **Simplify the individual income tax**

Utah's educational needs are chiefly funded by the individual income tax, the property tax and to a lesser extent by the corporate income tax. As we have previously noted, these are Utah's most volatile (least stable) taxes. Figure 5 shows that with no growth in nonagricultural wages, and based on our findings about the personal income tax, the income tax base will decline. Figure 6 illustrates the expected growth when nonagricultural wages increase by 4%. The uppermost triangle in Figure 6 reflects the net new revenue coming from the income tax and the middle triangle illustrates the amount of revenue needed to offset the decline in the tax base.



**Figure 5. Change in the individual income tax base assuming 0% growth in nonagricultural wages, 2004-2009.**

In an effort to add more stability to the educational tax structure we propose a restructuring of the individual income tax. Two goals will be achieved by this restructuring. First, a more stable tax base will be created by shifting more educational funding to property tax. Second, we believe significantly lowering the individual



**Figure 6. Change in the individual income tax base assuming a 4% growth in nonagricultural wages, 2004-2009.**

tax rate will provide additional long range revenue by stimulating business development.

Currently, Utah's individual income tax appears to be progressive, with bracketed rates ranging from 2.3% to 7%. The top rate, however, begins at about \$8,600 for a married couple filing jointly and about \$4,300 for a single person. In Idaho, in contrast, the top rate for joint filers begins at over \$21,000 and in Arizona it begins at \$150,000. (The top tax rates and level at which they occur in all Western states is demonstrated in Appendix 6.) Moreover, Utah's rate structure is not indexed for inflation and will continue to flatten in the future, even with only modest inflation. Thus, Utah's system is essentially a flat rate but it is a flat rate that was achieved by default not by careful design.

Utah also allows a series of deductions and credits, some of which are significant in terms of total dollars (e.g., the personal exemption, charitable contributions, federal income tax deduction) and some of which are not (the energy systems credit, the qualified sheltered workshop credit and the tutoring for disabled dependents credit together accounted for less than \$120,000 in tax savings state-wide in 2002).

### **Recommendation: Adopt a flat tax, broaden the base and lower the rate**

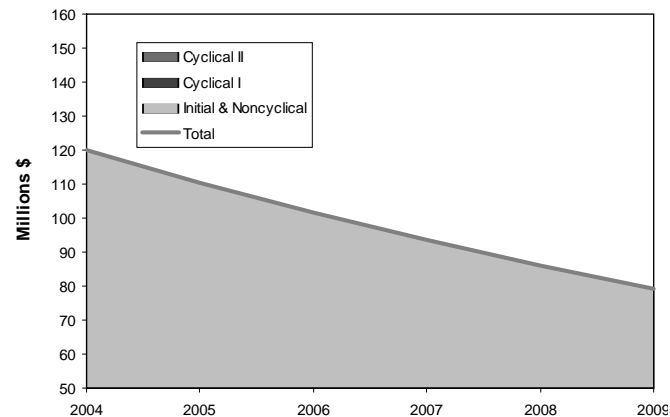
We believe we can increase economic development by lowering the rate. Accordingly, we recommend a single rate of 4.9% on federal taxable income.

We would require one adjustment to increase federal

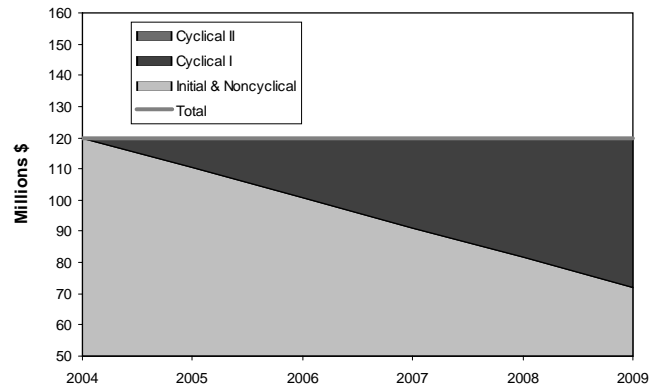
taxable income—for state income taxes allowed as an itemized deduction. It makes no sense to allow a deduction for Utah taxes in calculating the amount of Utah tax that should be paid. We would allow further reductions if they are constitutionally required, such as interest on federal debt obligations or certain income of Native Americans. The lost revenue would be replaced through an adjustment to the minimum school levy.

In the alternative, we recommend a single rate (approximately 4.1% would be revenue neutral) on federal adjusted gross income. No adjustment to the minimum school levy would be required. We would allow one deduction. Taxpayers at or below the poverty level should not pay income tax. Thus, we would allow a deduction, based on income level and family size, to ensure that the poorest among us continue to pay no state income tax. (A table showing that deduction, based on federal poverty levels, is attached as Appendix 7.) We would allow further reductions only if they are constitutionally required.

The additional significant advantage of either proposal is that most taxpayers will be able to complete a simple tax return in just a few minutes. Such a procedure would also move the state more rapidly toward a system of virtually complete electronic filing. Examples of simplified tax returns are attached in Appendix 8.



**Figure 7. Change in the corporate franchise tax base assuming 0% growth in nonagricultural wages, 2004-2009.**



**Figure 8. Change in the corporate franchise tax base assuming a 4% growth in nonagricultural wages, 2004-2009.**

### *Recommendation #3*

#### **Eliminate the corporate income tax**

We recommend elimination of the state corporate income tax. We recognize that it provides revenue for education financing. Over the last 5 years, the corporate tax has generated annual revenues ranging from \$120 to \$184 million. The corporate income tax, however, is relatively small compared to the individual income tax. In recent years, it has averaged less than 10% of individual income tax revenues and less than 5% of overall state revenue.

Figure 7 illustrates the expected decline in corporate tax revenue if there is 0% growth in nonagricultural wages over the period 2004-2009. Figure 8 shows that if nonagricultural wages grow at 4% the growth will not even fully offset the ongoing decline in the corporate income tax base. The upper triangle in Figure 8 simply represents the revenue from the corporate franchise tax needed to make the tax whole.

The state corporate income tax should be considered for elimination for several reasons. As just demonstrated, its base is declining. It is also a tax that presents numerous compliance challenges and these challenges are increasing from year to year. The corporate tax is difficult to calculate for multistate businesses and creates substantial uncertainty even for the most tax-savvy firms. It is also a tax that consumes significant audit resources of both businesses and the State Tax Commission. The lack of audit coverage encourages aggressive tax planning and creates unequal levels of compliance.

The elimination of the state corporate income tax is frequently on the list of recommended changes of many economists, legal experts, and accounting professionals who think about state and local taxation. The reasons for these views are varied but generally reflect the sense, at least among professional economists, that the state corporate income tax creates double taxation of income. There is also a growing belief among this group that the state corporate income tax is uniquely uneven with respect to the size of a firm or the nature of its business. Thus, elimination of the tax could enhance overall tax fairness.

Repeal of the state corporate income tax would send a strong message to local, national and international businesses that Utah has a business friendly environment. We believe elimination of the corporate tax would generate significant benefits for schools in the long run because of increased economic activity and development in the state.

In the short run, however, it would be necessary to replace the lost revenue. We believe the state-wide uniform school fund levy should be adjusted to offset this loss. That resulting tax burden would be much more widely distributed among all citizens and businesses in Utah, rather than focusing on just a few taxpayers. We would be replacing a highly volatile revenue source with a more dependable one. As noted in Figure 1, the corporate tax is the most volatile of our major taxes and is highly dependent on economic conditions. From 2001 to 2002, for example, the corporate income tax revenues dropped by more than 30%. The property tax, on the other hand, is the most stable of the major taxes. Thus, balancing the educational funding “portfolio” makes good sense in both the short run and the long run.

However, we recognize that because the corporate income tax provides needed revenue its immediate elimination may not be practical. If the corporate income tax cannot be eliminated, we recommend two significant adjustments.

### **Double weight the sales factor**

First, consideration should be given to double-weighting the sales factor. Income from multistate businesses is now apportioned among the states where the business is being conducted based on a formula that equally weights three factors— payroll, property and sales. When Utah adopted this formula, it was widely used. Since that time,

however, most states have moved to increase the weight given to the sales factor. This tends to shift the tax burden to out-of-state businesses that have sales in the state, but relatively little property or payroll. Only twelve states retain the traditional three-factor formula. The remaining states weight the sales factor from 60 to 100%. (Three states have no corporate income tax.) A map showing the distribution of states is attached as Appendix 9. Utah’s continued use of the traditional three-factor formula could discourage corporations from investing in payroll and property here. Moreover, because the goal of an apportionment system is to equitably apportion 100% of the income among the states—no more and no less— Utah should adopt a formula that more closely approximates what the majority of other states are doing.

### **Establish filing thresholds**

Second, Utah should adopt a minimum filing threshold. There is considerable uncertainty in the business community about when a corporation needs to file a return in any state. The statutory standard is currently “doing business.” It is not always easy to determine when a corporation begins “doing business in the state.” Most tax practitioners would agree that having an executive attend a seminar or a conference should not be enough. What if a corporate employee enters the state merely to buy supplies, equipment or raw material? What if a corporation sends its equipment into the state to be repaired? This proposal would answer such questions.

We suggest that the same factors that determine apportionment of income, i.e., payroll, property and sales, should be used to determine taxability itself. If a corporate taxpayer, not incorporated in Utah, does not have at least a minimum amount of one of the three apportionment factors in the state, it should be relieved of both the minimum tax requirement and the filing requirement. The minimum levels we propose are the lesser of \$50,000 or 25% of the corporation’s property, the lesser of \$50,000 or 25% of the corporation’s payroll, or the lesser of \$500,000 or 25% of sales. If a corporation has nexus with the state, as determined under Constitutional principles established by the courts, it would have to compute and pay a Utah corporate income or franchise tax under applicable statutes if it exceeds the threshold in any one of the factors.

We believe this test would bring an appropriate level of certainty to corporate tax compliance without significantly reducing revenue.

## *Recommendation #4*

### **Simplify and expand the sales tax exemption for business inputs**

One of the criteria for a fair and balanced system is that taxpayers know what taxes they are actually paying. In many cases, understanding what taxes an individual or family pays is more difficult than it may first appear. For example, taxes on business inputs are generally passed forward to the customer in the form of higher prices or passed backward to employees in terms of reduced wages.

There are, of course, some situations where the taxes are absorbed by the owners of the business firm. Those taxes, however, are hidden from the consumer, employee, and even the owner of the business. Moreover, if a customer is paying sales tax on the goods or services he or she is receiving, the customer may actually be paying a tax on a tax—the so-called “pyramiding” effect. A well-designed sales tax would be imposed only on final consumption.

Utah has limited “pyramiding” to some degree. Business inputs are exempted in some industries for some items, but not for others. Typically, manufacturing businesses have received appropriate treatment because policy makers believed that those policies would encourage businesses to locate new or expanded facilities in the state, thus creating high paying jobs for Utah citizens and they wanted to mitigate pyramiding. There are currently special exemptions for manufacturing businesses, airlines, ski resorts, TV and film producers, government contractors, steel mills and agriculture. Such exemptions minimize the problem of tax pyramiding.

Retailing, wholesaling, and utility firms, who are believed to locate facilities based on proximity to their markets, have typically not enjoyed such exemptions. We believe the current patchwork creates both the perception and reality of unfair treatment among industries. It clearly runs counter to the model of a fair and just tax system. It also reduces transparency in the system.

#### **Recommendation: Exempt business inputs from sales tax**

We recommend a uniform sales tax exemption on any asset purchased by a business that is manufacturing, distributing, selling or otherwise providing goods or

services. We also recommend that the exemption should be limited to property that can be capitalized under federal income tax law. Generally, such property must have a useful life in excess of one year. The exemption would apply to all property and services that have the requisite useful life, even if the taxpayer chose to expense the property under Section 179 or some similar provision of the Internal Revenue Code.

Supplies and services that have a useful life of less than one year would continue to be subject to sales tax unless they were actually incorporated into a product that was resold. For example, an auto body shop could continue to buy paint tax-free because it is incorporated into taxable painting and repair services.

We believe a uniform capital asset exemption is substantially more fair and balanced than the current structure and moves the sales tax toward a true consumption tax. We believe it creates a business-friendly environment. It should enhance the competitiveness of Utah products and services on the interstate and international markets by helping to reduce production costs.

## *Recommendation #5*

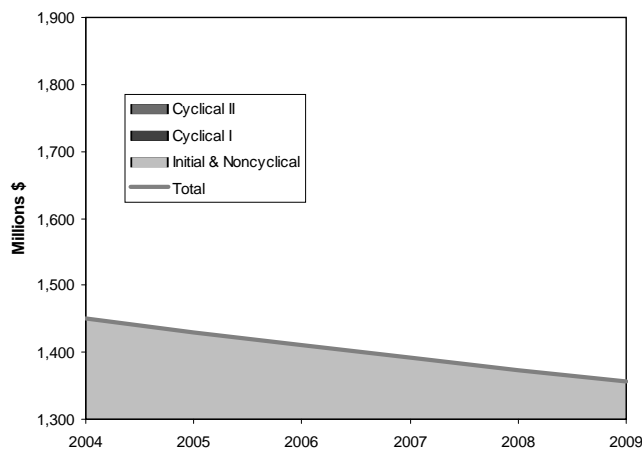
### **Broaden the sales tax to include services**

As the national and state economy has changed over the years, an increasing amount of personal consumption is now in the form of services, rather than goods. As a result of the shifting nature of the economy, the retail sales tax now reaches a decreasing share of consumption. (See Figure 9.)

This evolution has several unanticipated consequences. State governments have increased rates to make up for the narrowing sales tax base. This revenue-driven approach uses changes in rates to deal with lower revenue when the real problem is a changing base. This leads to further negative consequences. As the tax base decreases and the rate increases the sales tax also becomes more regressive. Those members of our society with the lowest disposable personal income must spend a higher proportion of that income on basic goods, such as food and clothing.

Moreover, in our modern economy, it is increasingly difficult to distinguish between property and services.

Many goods, such as books, magazines, videos, and CD's, are now available in digital form. It is also difficult to distinguish between the sale of information products and the sale of information services. For example, is a customized mailing list a taxable product or a non-taxable service? Or when a photographer is retained to take wedding pictures, is she providing a photography service or is she really selling the pictures she takes? The courts have wrestled with these and similar problems with varying results. We see no policy reason, however, why the sales tax consequences should be based on such distinctions. In fact, if the suggested changes are not adopted, the likelihood of a growing reliance on the courts to resolve the disagreements is almost a guaranteed outcome.



**Figure 9. Change in the retail sales tax base assuming 0% growth in nonagricultural wages, 2004-2009.**

Many services, of course, are provided to businesses. Those businesses use such services in providing products to the ultimate consumer. A tax on services to businesses would exacerbate the “pyramiding” problem discussed above. It would make Utah products and services less competitive with interstate and international competition. To avoid this problem, we recommend taxing services only if they are provided to ultimate consumers.

It is difficult to “source” services. If you are taxing the sale of tangible property, you typically know where the property is being purchased or used. You cannot always determine where intangible property or services are being used. Utah law currently says that services should be taxed to the jurisdiction where the recipient “mak[es] first use of the services.” Utah Code Ann. 59-12-207.1. This is language required by the Streamlined Sales Tax

Project (the “SSTP”) and will be applied uniformly by the states adopting the SST Agreement. (The SSTP will be discussed in more detail in Recommendation 6.) Accordingly, guidance will be forthcoming on the application of this provision on a national level. Moreover, because services to businesses will not be taxed, these sourcing problems will be minimal. Most individuals will make first use of services either at the location of the service provider or at their own homes. Utah professionals will not be at a competitive disadvantage in performing services for out-of-state clients because those clients would make use of the services out-of-state and would not be subject to Utah tax. Out-of-state businesses who came into Utah to perform services would be subject to the same collection obligation as local businesses.

### **Recommendation: Include a sales tax on services**

We believe it is appropriate to impose a sales tax on services, including professional services, but only if they are provided to personal consumers. This broadens the base significantly, thus making the tax more balanced and fair. It is business friendly because it shares the sales tax burden over all segments of the economy, rather than burdening only traditional retailing. It recognizes the economic trends of the 21<sup>st</sup> Century and will enable the state to meet its critical funding needs without further increasing sales tax rates. And, because local governments also rely heavily on sales taxes, it protects their revenues as well. This proposal does increase the compliance burden for service providers who would have to distinguish between taxable and nontaxable sales. Compliance could be accomplished through expanded use of exemption certificates.

## *Recommendation #6*

### **Monitor the rate of the sales tax**

We believe that broadening the sales tax base to include services will eventually raise a significant amount of new revenue. We feel strongly that raising revenue, if necessary, from a broad base causes far fewer distortions than increasing rates on a series of narrow bases. Under our proposal, we believe that the tax base will be larger eventually even after the exemptions for all business inputs are netted out.

The assumptions we made about the additional sales tax were very conservative and based on those outcomes we

optimistically expect that a revenue neutral state sales tax rate of 3.75% could be achieved. This rate would lead to a less regressive sales tax because the necessities purchased by the poor would be taxed at a lower rate and the services consumed by higher income individuals would now be taxed. It would also make the Utah sales tax rate among the lowest of all sales tax states.

Because of the fiscal importance of the sales tax and the difficulty of adequately determining the financial impact of the changes we have proposed, it is prudent to leave the current rate in place for the first year. The legislature should require automatic reductions in the tax rate when established revenue targets are met. Any surplus in the first year could replenish Utah's Rainy Day Fund or reduce existing state debt. Established insurance and risk management methodologies should be used to determine the appropriate size of the Rainy Day Fund. Once policy makers determine the optimum size of the Fund, it should be funded as soon as possible.

### *Recommendation #7*

#### **Continue to participate in the Streamlined Sales Tax Project**

We believe that Utah's continued participation in the Streamlined Sales Tax Project ("SSTP") is vital. It does not represent a new tax, but only allows a fair way to collect an existing tax. A study by Donald Bruce and William Fox, of the University of Tennessee, indicates that Utah will lose over \$180 million in sales tax revenues in 2008 due to electronic commerce. In addition, "main street" Utah businesses will continue to be at a competitive disadvantage as they collect sales tax where an out-of-state seller does not. The cost difference to the consumer will continue to drive consumers to the remote seller. A copy of the report is attached as Appendix 10. We believe that Internet and other forms of remote commerce will continue to grow.

Because of the high volume of such sales and the relatively low dollar amount of each sale, it is not economical to aggressively enforce the existing use tax on such purchases by individual consumers. The SSTP, if fully implemented by the states and approved by Congress, will meet all of the Governor's objectives. The SSTP is fair because all consumers will pay tax on the same purchases, regardless of their access to the Internet (and the credit necessary to make Internet purchases).

The Project is business friendly to "main street" Utah businesses since they will no longer be at a competitive disadvantage with remote sellers. The Project will prevent the further erosion of sales tax revenues as it recognizes and responds to 21<sup>st</sup> Century business practices. Finally, because sales tax is important at both the state and local level, protection of the sales tax promotes a proper balance of state and local revenue. Gary Cornia, David Sjoquist, and Larry Walters offer evidence that the adoption and implementation of the provisions of the SSTP process will increase voluntary compliance with the use tax by multistate vendors even if Congress does not act. A copy of their report is attached as Appendix 11.

### *Recommendation #8*

#### **Simplify the rate structure and distribution of the local sales tax – distribute the sales tax based upon population**

Utah currently has a plethora of local sales taxes that retailers must collect, including the uniformly adopted 1.0% local tax, the resort communities tax, the public transit tax, the highway tax, city and county option ZAP taxes (for botanical, cultural, recreational, and zoological facilities), and rural hospital taxes. Utah now has 13 combined rates, ranging from 5.75% to 8.00%. (A listing of the jurisdictions and their rates is attached as Appendix 12.)

The SSTP when fully implemented will require remote vendors to keep track of all the rates in order to collect Utah's sales taxes. The remote retailers must then attribute their sales to 97 different jurisdictions where goods and services are shipped. Under federal law, Utah cannot impose a heavier burden on remote sellers than we do on our local merchants. A local merchant must also keep track of sales by delivery location according to the SSTP requirements. This is a significant burden on small merchants. In an economy that competes for multistate and international sales it is counter productive to saddle any retailer with a multitude of local option sales taxes.

The broadening of the tax base recommended above will result in increased sales tax revenues to local governments. An appropriate trade off for this increased revenue would be the simplification of the local government rate structures. Ideally, all local option taxes should be phased out to the extent they apply to general

retailers. All Counties should have a uniform local tax rate, which would include the current general tax and a highway or transit tax. Those tax revenues could then be distributed among the local governments based on population. The formula could also take into account day-time population or seasonal population to recognize the fact that many communities provide services to commuters or tourists who reside in other jurisdictions.

We recommend a single combined sales tax rate for the entire state. Retailers, whether remote or local, would collect a single rate and would report all their sales to the State on a single line on the sales tax return. They would not be required to keep track of where deliveries were made.

#### **Eliminates “zoning for dollars”**

Another significant benefit of this proposal is the elimination of “zoning for dollars” that exists under the current system. Basing tax distribution to the local entities on population would allow local governments to make land use and economic development choices on sound economic policy, not revenue.

#### **Hold harmless provision**

To transition to a new distribution system local governments that would lose revenue under the new system should be held harmless and be guaranteed at least as much revenue as they had received in the previous year. If the tax base is broadened to include services, losses could be potentially made up with new revenue.

#### **Tourism related local options**

Localities would also retain the option they currently have to impose specific sales taxes on hotel accommodations, restaurants and automobile rentals. This will minimize the impact of the change on commercial and tourist centers, without significantly burdening general retail merchants. Those services are provided locally and the service providers need not track applicable rates in jurisdictions where they are not physically present.

#### **City and town sales tax options**

If this proposal is not implemented in its entirety, city and town level option taxes should nevertheless be eliminated. Transit districts should have boundaries that are congruent with County lines. If these proposals are adopted, retailers would only have to report the county

of delivery, thus reducing their burden significantly. (Currently, Daggett, Davis, Millard, Morgan, Piute, Wayne and Weber Counties already have a single combined county-wide rate. Beaver, Duchesne, Emery, Grand, Iron, Juab, Rich, Salt Lake, San Juan and Uinta Counties only have two rates. A listing of the jurisdictions that retailers must currently keep track of, and the applicable rate, is attached as Appendix 13.)

### *Recommendation #9*

#### **Retain the general structure of the current property tax system.**

We looked closely at the property tax system. Utah has a strong uniformity and equalization clause in its Constitution that requires most property to be taxed at full fair market value. Utah is one of a handful of states that assesses and reports property and improvements at full market value. This practice is an important ingredient in keeping the property tax transparent and understandable to property owners. Exceptions are made for charities, schools, agricultural land and miscellaneous other exemptions. The Constitution also allows a reduction of up to 45% in taxable value for primary residences. We believe this basic structure is sound and should be retained.

### *Recommendation #10*

#### **Fund urban and suburban water use with fees, rather than property tax revenues or sales tax**

Utah water districts regularly impose property taxes to defray the cost of water. We believe that water is primarily a commodity that should be paid for by the people and entities using the water. One person's excessive water use should not be subsidized by other taxpayers.

The Tax Review Commission, after careful study, recommended that water systems should generally be funded by user fees and not property tax. This recommendation is based on sound and established economic principles. We adopt their recommendation. The current system leads to subsidized rates and they in turn lead to overuse of water. Utah is one of the driest states in the nation, yet our per capita water use is second in the nation. A recent series of reports by the

Utah Foundation amplifies these issues. These reports are found in Appendix 14.

Only a portion of the cost of water is collected from water user fees. Much of the “cost of water” is buried in the property tax. Therefore, the true cost of water is not obvious to the consumer and there is little incentive to save water. We recommend that the entire cost of water be funded through user fees. This would make the cost of water visible to the user, causing pain at the tap and encouraging conservation.

A corollary problem would also be solved. The current practice of funding water through property tax causes business to subsidize the cost of water. Financing water through user fees would not only incentivize business users to conserve water, it would also eliminate this subsidy.

Water also receives a sales tax subsidy. One-sixteenth of a cent of sales tax, roughly \$17.5 million goes directly into water loan funds. The funds are used for agricultural, municipal and industrial water. When subsidized agricultural water is sold for development, the intended subsidy benefits neither agriculture nor our citizens.

### **Agricultural water**

There are two problems raised by this recommendation. The first involves water systems that are primarily devoted to agricultural irrigation. The operators of those systems argue that farmers and ranchers cannot afford the increased fees that would be necessary if the tax subsidies for water provided by other business and individual taxpayers were taken away. Some rural districts that have extraordinary delivery costs have similar arguments. We believe their concerns are justified. Although we would like to see alternative funding mechanisms for rural water systems, we do not have any to recommend at this time. Accordingly, we recommend retaining the property tax authority for rural water districts that can meet appropriate criteria.

We note however that unless the issue of subsidized water rates is addressed for urban areas the groups most at risk are the agricultural users. Subsidized water rates in urban areas increase the demand for water and place increasing pressure for rural water to be appropriated for urban use. Economist Del Gardner, a leading expert in

western water issues, illustrates the current economic disincentives in Appendix 15.

### **Financing water**

Suburban water districts also argue that operating revenues would not be sufficient to fund their needs if they were involved in a large capital expansion. This is particularly true where a new water system is needed for a large residential development. The water system must be in place and operating before the homes can be sold. Thus, the expenditures and the water usage fees do not match. We believe this problem can be solved by continuing the revolving loan funds, perhaps funded by the state or by tax-exempt bonds guaranteed by the state that would provide capital facilities financing for new or rapidly growing districts. (If state guaranteed bonds are used, the required due diligence must be met to ensure that the State’s credit is not put at risk.) As those districts mature, they would pay off the bonds and the replenished funds could then be loaned to new districts. Mature districts would be required to pay for operating expenses and reasonable capital replacement and expansion costs out of operating revenues. An alternative approach would be to establish multi-tiered rates that would impose a surcharge for financing capital facilities. Such a method would help insure that new participants in the water district would not be subsidized by established water users.

## *Recommendation #11*

### **Study centrally-assessed property**

One of the most contentious issues in property tax is the valuation of centrally-assessed taxpayers, such as utilities, oil and gas and mining companies. The percentage of the overall property tax burden borne by such taxpayers has declined over the last several years. (See Appendix 16.) Many local governments believe this demonstrates that such taxpayers are undervalued. The centrally-assessed taxpayers, on the other hand, argue that the reduction reflects changes in the economy and their own operations. They argue that their properties are still generally overvalued and claim that Utah system values are among the highest of any state in which they do business. Appendix 17 offers a report conducted by finance and policy professors at the University of Utah and Brigham Young University that generally validates the claim that the assessed values imposed by Utah are among the highest in the Western United States.

We have not attempted to independently assess the validity of either side's claims. The fair market value of any property is a factual issue on which reasonable minds can differ. Three changes have been made in recent years, however, that address these concerns.

First, the Tax Commission, after lengthy hearings has adopted a rule to provide consistent guidance on the valuation of most centrally-assessed taxpayers. Second, both taxpayers and Counties now have access to a trial de novo in District Court. Third, the Tax Commission has recently limited the number of continuances that can be granted in property tax cases in an attempt to reduce the impact on the Counties caused by large refunds.

**Recommendation: a summit meeting should be convened**

We believe the only way to definitively solve this problem would be to amend the Constitution to allow a different tax, such as a gross receipts tax, for these taxpayers in lieu of a property tax. We do not believe this approach is either fair or business friendly. Accordingly, we recommend no changes in this area.

We recognize, however, that there is a significant level of concern about this issue on the part of both centrally-assessed taxpayers and local government leaders. We believe this concern can be reduced if a summit meeting is convened of the parties involved. Participants must include high-level executives of the taxpayers and elected state and local officials. The summit, to be helpful, must be more than another opportunity for tax professionals on both sides to restate the arguments they have made to the Tax Commission in hearings and rule-making proceedings. We do not necessarily suggest excluding tax professionals. We believe, however, that it would be productive to have top executives from both sides share their concerns and frustrations directly with each other. At the least, they can establish lines of communication and eliminate counterproductive misunderstandings.

*Recommendation #12*

**Allow school districts and other special districts to benefit from redevelopment initiatives**

Utah, like many states, has adopted a policy that allows cities to establish a redevelopment agency. These are commonly referred to as RDA's. The RDA is supposed

to be established in a "blighted" area of the city to help facilitate the redevelopment of the city. Cities can use their RDA authority to acquire land, offer tax incentives, and develop infrastructure. Depending on the degree of blight, the amount of the incentive, and other market factors, RDA's may have varying degrees of success in achieving their goals.

The current system allows the city to receive a significant portion of property tax revenue on the increased value of the property—the value after the new development has been established—for a period of twenty years. Public entities other than the city, such as the county and school district, receive a smaller share of the revenue. The RDA is able to retain much of the property tax on the incremental value. Thus, the school districts and other local entities do not fully benefit from the increased property values for twenty years

In Utah, over 50% of property tax revenue normally goes to schools. Allowing the schools to receive the property tax increment would provide considerable additional revenue. In 2002 this amount would have been over \$35 million. Allowing districts to opt out would, of course, limit the resources of the RDA's and make additional developments harder to finance. On balance, however, we believe the needs of the schools outweigh the needs of the RDA's for the foreseeable future. Other taxing districts similarly have their revenues restricted by RDA's.

**Recommendation: Allow all affected entities to opt out of the RDA financing**

We believe taxing entities should only participate in the tax increment financing if they choose to do so.

*Recommendation #13*

**Adjust property tax rate for inflation**

The Truth-in-Taxation law was adopted in the mid 1980s amid serious public concern about rising property taxes. The law requires that any increase in the effective tax rate must be communicated to taxpayers by legal notice. Truth-in-Taxation has undoubtedly resulted in a reduced rate of increase in the property tax. There have also been some unintended outcomes associated with this law. There has been a notable increase in the number of special tax districts. Thus, rather than make government more transparent, the outcome has been less

transparency. Local officials have complained that the requirements are so restrictive that essential services are being reduced. It has diminished the autonomy of local government. This point has some validity because the current law requires local government to absorb any increases in government costs that are associated with inflation over which local governments have no control. This undermines the ability of local governments to fund essential services. The loss of such services diminishes the quality of life in Utah.

We recommend that local government be allowed to index their property tax rates by the annual change in the consumer price index. Adopting this action would enhance the autonomy of local governments and special districts and will signal legislative trust in local elected officials.

### *Recommendation #14*

#### **Modify motor fuel taxes – fuel tax and sales tax**

The state, for fiscal year ending June 30, 2003, spent about \$635 million on highways from sales taxes, motor fuel taxes, special fuel taxes, federal funds, and registration fees. Local government entities spent about \$250 million on roads. Some highway financing, of course, comes from state bonds, but the debt service on those bonds, as well as other operating costs of the Department of Transportation, should be financed with fuel taxes and other road user fees such as vehicle registration.

This is an area in which we believe it is appropriate to more closely match the use of the government services, the roads and highways, with charges to those actually using those facilities. The same principles should apply to local governments and their roads. The cost of maintaining and building local roads should be financed by the citizens and businesses using those roads.

Currently, fuel taxes are \$0.245 per gallon. Federal excise taxes are also on a “cents per gallon” basis. This methodology provides more stability than applying the tax on sales price. The methodology does not allow revenues to keep pace with general increases in inflation, however, because fuel taxes are generally exempt from the sales tax. Given the relatively high level of fuel tax, this exemption appears reasonable.

#### **Recommendation: Impose both a sales and a fuel tax**

We believe a better structure would be to impose both a sales tax (percentage-based) and a fuel tax (cents per gallon-based) on gasoline and diesel fuel. The existing fuel tax rate should be adjusted, however, to avoid a revenue windfall.

This proposal would retain the stability of the per gallon rate while adding the growth potential of a sales tax. This will help match the inflation growth of the cost of building and maintaining roads with the revenues. It would also provide needed funding to local governments for their street funding needs.

We do not necessarily recommend immediate action. Gasoline prices are currently unstable and it may be difficult to establish a reduced motor fuel rate that will be revenue neutral. The next time policy makers believe an increase in fuel tax revenue is necessary, however, we recommend removing the sales tax exemption and reducing the fuel tax rate accordingly.

### *Recommendation #15*

#### **Simplify the severance tax and invest the proceeds**

Severance taxes, particularly the oil and gas severance tax, have received significant legislative attention this year, in part because of high oil prices and in part because of the recent Utah Supreme Court decision in *ExxonMobil v. State Tax Commission*.

The Legislature addressed oil and gas severance tax in Senate Bill 191 (2004). This bill contemplates further legislative scrutiny of the structure and level of tax. Accordingly, we do not wish to duplicate these efforts or anticipate their results. We make no recommendations on the level of the tax at this time. However we do recommend that the two tier system be eliminated. We note that Mitch Kunce, Shelby Gerking, William Morgan, and Ryan Maddux presented a study on oil and gas severance tax rates for the Tax Review Commission. A copy of that report is attached as Appendix 18.

We have two additional recommendations that are relevant to the severance tax. First, we have already proposed a uniform sales tax exemption on capital

equipment. If adopted, this exemption will reduce the overall tax burden on the mining and oil and gas industries, thus making Utah exploration and production more economical. Such savings should be considered by the Legislature in evaluating the appropriate level of severance tax.

Second, we note that our mineral resources are non-renewable. New deposits will be found and more efficient recovery techniques will no doubt be developed. Accordingly, we do not expect severance tax revenues to disappear any time soon. But the simple truth remains that once the minerals are extracted, they are gone. Spending tax revenues from a depleting asset for day-to-day operational needs appears to us to be imprudent. We recommend that the Governor and the Legislature dedicate a significant portion of the severance tax revenues to long-term investments, whether in trust funds, capital projects or economic or community development. The revenue from these depleting assets should be used to create other assets for the citizens of the state.

### *Recommendation #16*

#### **Retain the state inheritance tax unless the federal estate tax is finally eliminated**

The federal estate tax is currently being phased out and will be totally eliminated in 2010. Due to the idiosyncrasies of federal budget making, however, the tax is scheduled to be resurrected in 2011. The federal estate tax currently allows a credit for state inheritance taxes paid. Traditionally, a state could impose an inheritance tax up to the amount of that credit without increasing the overall tax burden on the decedent's estate. However, the federal law phases out the state tax credit more rapidly than the federal estate tax.

We believe the state inheritance tax should be retained as long as there is a federal estate tax. It affects primarily high-income taxpayers and adds nothing to their overall burden. If the federal estate tax goes away permanently, however, we believe the state inheritance tax should also be repealed. Much of the state inheritance tax may already be avoided with careful estate planning. Well-advised taxpayers can pay little or no tax, while unwary taxpayers, or those who die prematurely, can pay relatively large taxes. Moreover, inheritance taxes can be easily avoided by moving out-of-state. We do not want

to provide additional incentives for wealthy individuals to move away. We want them to stay in Utah and continue to contribute to our society, both financially and with their accumulated wisdom and experience.

Accordingly, we believe that no change is necessary in Utah law. It currently allows a state inheritance tax at the maximum amount that will be allowed as a credit by federal law. Although this credit will continue to decrease, and the tax revenues will continue to decrease concomitantly, we do not recommend imposing a tax that will be an additional burden on the estates of some of our most productive citizens.

# Appendices

1. Utah's Tax Portfolio: Current and Future Characteristics, an Examination of Utah's Tax Base. Prepared by Governor's Tax Review Advisors
2. Chart of Relative Tax Growth of Utah's Three-Legged Stool
3. Table of Utah Revenues (1982-2003)
4. R. Cline, W. Fox, T. Neubig and A. Phillips "Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in FY 2003" prepared for the Council on State Taxation (2004)
5. D. MacDonald "Western States' Tax Burdens, Fiscal Year 2002-2003 (Revised)" Utah State Tax Commission, Economic and Statistical Unit (2004)
6. Map of Comparative State Individual Income Tax Rates and Brackets
7. 2004 HHS Poverty Guidelines, U.S. Department of Health & Human Services
8. Example of recommended individual income tax form
9. Map of State Income Tax Apportionment Factors prepared by Utah Office of Legislative Research and General Counsel
10. D. Bruce and W. Fox "State and Local Tax Revenue Losses for E-Commerce: Updated Estimates" Center for Business and Economic Research, University of Tennessee (2004)
11. G. Cornia, D. Sjoquist and L. Walters "Study on Voluntary Sales Tax Compliance" (2004)
12. Table of Combined State and Local Tax Rates by Jurisdiction (2004)
13. Combined Sales Tax Rates under SST
- 14a. Utah Foundation "Creating an Oasis: Water Development and Funding in Utah" (2002)
- 14b. Utah Foundation "Creating an Oasis Part 2: Water Consumption Pricing and Conservation in Utah" (2002)
15. D. Garder "Using Property Taxes in Lieu of Direct User Fees to Pay for Water" Brigham Young University
16. Comparison Chart of Centrally-Assessed and Locally-Assessed Values and Taxes (1992-2000)
17. L. Walters, J. Pinegar, J. Schallheim. "A Review of Centrally-Assessed Property Tax Issues in Utah" (1997)
18. M. Kunce, S. Gerking, W. Morgan, R. Maddux. "State Taxation, Exploration and Production in the U.S. Oil Industry" (2002)
19. Tax Advisory Board Bios